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No. 84-276

In the Supreme Court of the United States

OCTOBER TERM, 1984

TEXAS FARM BUREAU, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

A.R. Lantz Co. v. *United States*, 424 F.2d 1330 ..... 6, 7

Austin Village, Inc. v. *United States*, 432 F.2d 741 ..... 6, 7

Bonner v. *City of Prichard*, 661 F.2d 1206 6

Brake & Electric Sales Corp. v. *United States*, 287 F.2d 426 ..... 6, 7

Diamond Bros. v. *Commissioner*, 322 F.2d 725 6

Estate of Mixon v. *United States*, 464 F.2d 394 6

Gilbert v. *Commissioner*, 262 F.2d 512, cert. denied, 359 U.S. 1002 6

Lundgren v. *Commissioner*, 376 F.2d 623 6

Piedmont Minerals Co. v. *United States*, 429 F.2d 560 7

Ragland Investment Co. v. *Commissioner*, 435 F.2d 118 6

Road Materials, Inc. v. *Commissioner*, 407 F.2d 1121 6

Scriptomatic, Inc. v. *United States*, 555 F.2d 364 6

Taft v. *Commissioner*, 314 F.2d 620 6

Uneco, Inc., In re, 532 F.2d 1204 7

Page

Cases—Continued:

United States v. *Generas*, 405 U.S. 93 5

Williams v. *Commissioner*, 627 F.2d 1032 6

Statutes and regulation:

Internal Revenue Code of 1954 (26 U.S.C.):

§ 166 5

§ 166(a) 4

§ 501(c)(5) 3

§ 511 3

Treasury Reg. § 1.166-1(c) 5

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Petitioner challenges the court of appeals' determination that it was not entitled to a bad debt deduction for the tax years at issue, a determination based on the conclusion that petitioner's cash advances to an affiliated corporation were properly to be characterized as contributions to capital rather than as bona fide loans.

1. The operative facts were largely stipulated. Petitioner is a nonprofit corporation that provides services to people engaged in agriculture (Pet. App. A2). Petitioner generally provides these services through affiliated corporations established and managed by it (*ibid.*). This case involves transactions between petitioner and one of those affiliates, Texas Agricultural Marketing Development Association (TAMDA).

Petitioner formed TAMDA in 1961 to furnish cooperative marketing services to petitioner's members (Pet. App. A3). TAMDA and petitioner have always had the same board of directors, and all of TAMDA's members are members of petitioner (*ibid.*). Petitioner contracted to supply all necessary management and clerical services to TAMDA in exchange for reimbursement of expenses and a "reasonable management fee" (*id.* at A4). In practice, the management fee was rarely paid.[1] To meet its organizational and operating expenses, TAMDA relied on two sources of funds: membership dues and cash advances from petitioner (*id.* at A3). TAMDA's membership dues were nominal during the period at issue, amounting to about $3,000 annually.[2] The vast bulk of TAMDA's available funds — approximately $167,000 from 1961 to 1970 — took the form of cash advances from petitioner (*id.* at A4).

Apart from a single $50,000 advance made in 1967, none of petitioner's advances to TAMDA were evidenced by notes or other debt instruments (Pet. App. A5).[3] The parties made no provision for payment of interest on this "non-evidenced indebtedness," and TAMDA did not in fact pay any interest (*ibid.*). Except for a $3,000 payment in 1966,

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[1]Petitioner did not collect any management fee from TAMDA from 1961 to 1967 (Pet. App. A4 n.3). In 1968, petitioner charged a management fee of $74,400; TAMDA paid only $25,467 of this amount, and petitioner wrote off the remaining $48,933 as uncollectible (*ibid.*). The proper tax treatment of the managment fee is not involved here.

[2]TAMDA had 600 members during the relevant period, each member paying $5 in annual dues (Pet. App. A3, A14 n.14).

[3]The $50,000 advance made in 1967 was apparently evidenced — originally, at least — by promissory notes bearing a 7% interest rate (Pet. App. A5). No interest was ever paid on the notes, however, and they had no fixed repayment schedule and no maturity date. The notes were not placed in the record, having been "either lost or destroyed." *Ibid.*

TAMDA did not repay any of petitioner's advances. Petitioner proceeded to advance TAMDA $84,000 in 1969-1970, even though petitioner had written off TAMADA's $48,933 accrued management fee as uncollectible in 1968 (see Pet. App. A5 and note 1, *supra*). Petitioner never brought suit to collect any of the amounts assertedly owed by TAMDA (Pet. App. A5).

On its 1970 tax return, petitioner sought to deduct as a worthless bad debt the sum of $164,000, representing its cumulative unrepaid advances to TAMDA from 1961 through 1970 (Pet. App. A5).[4] The Commissioner disallowed the claimed deduction, taking the position that petitioner's advances were not bona fide loans, but rather were contributions to capital which, because they did not become wholly worthless in 1970,[5] were not deductible in that year.

Petitioner paid the resulting deficiency and sued for a refund in the United States District Court for the Western District of Texas. The court denied the government's motion for a directed verdict and submitted to the jury the question whether petitioner's advances to TAMDA were loans or contributions to capital. The jury concluded that the advances were loans and that 98% of the advances had become worthless in 1970 (Pet. App. A17-A18). The district court denied the government's motion for judgment notwithstanding the verdict (*id.* at A6).

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[4]As a nonprofit agricultural association, petitioner is exempt from the regular corporate income tax under Section 501(c)(5) of the Internal Revenue Code (26 U.S.C.). Petitioner, however, is subject to tax on its "unrelated business income" by virtue of Code Section 511. By claiming a $164,000 bad debt deduction for 1970, petitioner wiped out its unrelated business income tax liability for that year and generated net operating loss carrybacks to 1967 and 1968. Pet. App. A6 & n.6.

[5]TAMDA did not cease to do business during 1969-1970 and was operating normally at the time of trial. Pet. App. A5.

The court of appeals unanimously reversed (Pet. App. A1-A16). It recited 13 factors commonly used by the courts in deciding whether ambiguous payments represent equity investments or loans (*id.* at A8-A9), and held that, since consideration of these factors "requires not a simple counting process, but an evaluation," the proper characterization of petitioner's advances "present[ed] primarily a question of law" (*id.* at A9-A10). While the jury in this case could have found a few of the factors (such as the parties' subjective intent) to "point weakly towards debt" (*id.* at A11), the court held that the vast majority of the factors "unwaveringly indicate[d]" (*id.* at A13) that the advances were capital contributions:

> The absence of fixed, realistic dates for repayment, the failure to provide for meaningful enforcement mechanisms, the dependence of TAMDA upon its earnings to repay the advances, the *de facto* subordination of [petitioner's] debt to other debt, the use of the advances for initial operating expenses, and the lack of emphasis on interest cut strongly against the notion that the advances were debt. * * * [Petitioner] hoped to profit by its relationship with TAMDA and furinished the capital to keep it going. No other scenario can be reeled out.

(Pet. App. A15-A16). The court of appeals concluded that the jury could have found the advances debt only by placing improper reliance on the parties "pious declarations of intent," to the exclusion of more weighty objective factors, and accordingly held that "the district court erred in not finding that the advances were, as a matter of law, contributions to capital" (*id.* at A16).

2. Section 166(a) of the Code allows as a deduction "any debt which becomes worthless within the taxable year." Only a "bona fide debt," that is, a debt "which arises from a

debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money," qualifies for purposes of Section 166. Treas. Reg. § 1.166-1(c). A gift or contribution to capital "shall not be considered a debt" for this purpose (*ibid.*).

The facts of this case overwhelmingly demonstrate that petitioner's advances to TAMDA were not debt. The monies advanced, with the exception of $50,000 covered by notes, were transferred without any evidence of indebtedness and created no realistic creditor safeguards and no genuine expectations of repayment. The notes were unsecured, were due on demand, and were not even in existence by the time of trial. Petitioner never demanded repayment of any of its advances, even though TAMDA timely paid all its other creditors in full. TAMDA never paid any interest on petitioner's so-called loans, and made over a 10-year period but a single principal payment in the nominal amount of $3,000. Notwithstanding TAMDA's repeated failures to pay principal and interest, and notwithstanding petitioner's own write-off of TAMDA's management fee as uncollectible, petitioner continued to advance TAMDA substantial sums of money, something no rational creditor would ever have done.

On these facts, the district court plainly erred in denying the government's motion for a directed verdict and in submitting the question of the character of the advances to the jury, since reasonable men could not possibly conclude that the advances created bona fide indebtedness. The court of appeals thus correctly reversed the district court and directed that judgment be entered for the United States. See *United States* v. *Generes*, 405 U.S. 93, 106-107 (1972).

3. As petitioner notes (Pet. 6), the courts of appeals have long disagreed — at least superficially — about how debt/equity questions should be characterized for purposes

of appellate review. The court below, adhering to its long-standing tradition, viewed that determination as "present-[ing] primarily a question of law" (Pet. App. A10 (footnote omitted)).[6] Other circuits have variously characterized the determination as a "question of fact,"[7] as "essentially a question of fact," [8] and as a "mixed question of law and fact." [9] Different panels of the same circuit have routinely described the exercise in contrasting ways.[10] And the courts have regularly responded to this apparent diversity of views by observing that the outcome would be the same regardless which view were adopted.[11]

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[6]Accord, *e.g.*, *Estate of Mixon* v. *United States*, 464 F.2d 394 (5th Cir. 1972). The Eleventh Circuit, in accordance with its announced policy of following Fifth Circuit decisions issued before October 1, 1984, will likely take the same approach. See *Bonner* v. *City of Pritchard*, 661 F.2d 1206, 1207 (11th Cir. 1981). The Tenth Circuit takes that approach as well. See *Williams* v. *Commissioner*, 627 F.2d 1032, 1035 (1980).

[7]*E.g.*, *Diamond Bros.* v. *Commissioner*, 322 F.2d 725, 730 (3d Cir. 1963); *Road Materials, Inc.* v. *Commissioner*, 407 F.2d 1121, 1123-1124 (4th Cir. 1969).

[8]*E.g.*, *Brake & Electric Sales Corp.* v. *United States*, 287 F.2d 426, 428 (1st Cir. 1961); *Gilbert* v. *Commissioner*, 262 F.2d 512, 513-514 (2d Cir.), cert. denied, 359 U.S. 1002 (1959).

[9]*E.g.*, *Taft* v. *Commissioner*, 314 F.2d 620, 622 (9th Cir. 1963).

[10]Compare *Scriptomatic, Inc.* v. *United States*, 555 F.2d 364, 372 n.13 (3d Cir. 1977) (question of law), with *Diamond Bros.* v. *Commissioner*, 322 F.2d 725, 730 (3d Cir. 1963) (question of fact); and compare *Ragland Investment Co.* v. *Commissioner*, 435 F.2d 118, 120 (6th Cir. 1970) (question of fact), with *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970) (question of law); and compare *A. R. Lantz Co.* v. *United States*, 424 F.2d 1330 (9th Cir. 1970) (question of fact), with *Taft* v. *Commissioner*, 314 F.2d 620, 622 (9th Cir. 1963) (mixed question of law and fact).

[11]See, *e.g.*, *Austin Village*, 432 F.2d at 745; *Lundgren* v. *Commissioner*, 376 F.2d 623, 625-626 (9th Cir. 1967).

Petitioner errs in contending that this heterogeneity of verbal attitudes — which have coexisted quite happily for 25 years — constitutes a "conflict in the circuits" requiring this Court's review. These diverse formulations reflect the obvious fact that debt/equity questions involve a melange of "factual" and "legal" considerations. Once the operative facts are established, the court must analyze those facts under the relevent legal criteria — the 13-factor "laundry list" used by the court of appeals here — according each factor its proper weight and balancing one against the other to determine the proper legal characterization of the instrument involved. See, *e.g.*, *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970). Under these circumstances, it is not likely to make any difference whether the court of appeals approaches its task by asking whether the trial court drew the correct inference of ultimate fact, subject to review under the "clearly erroneous" standard, or by asking whether the trial court analyzed the undisputed facts under the correct legal criteria, applying no irrelevant factors and avoiding undue emphasis on one factor to the exclusion of others. See, *e.g.*, *In re Uneco, Inc.*, 532 F.2d 1204, 1209-1210 (8th Cir. 1976); *Austin Village*, 432 F.2d at 745; *Piedmont Minerals Co.* v. *United States*, 429 F.2d 560, 562 & n.4 (4th Cir. 1970); *A. R. Lantz Co.*, 424 F.2d at 1333-1334; *Brake & Electric Sales Corp.*, 287 F.2d at 428. In short, whether the question should be styled one of fact or of law is a matter of little more than philosophical interest.

That is plainly the situation here. The court of appeals decided that the government was entitled to judgment because the district court could have labeled petitioner's advances debt only by focusing erroneously on the parties' "pious declarations of intent," to the exclusion of numerous objective factors which "unwaveringly indicat[ed] that the

advances were not debt" (Pet. App. A13-A14, A16). That decision could be equally characterized as a holding that the district court's inference of ultimate fact was "clearly erroneous," or as a holding that the district court erred as a matter of law by improperly balancing the relevant legal criteria. Because the court of appeals reached the right result for the right reasons, and because it plainly would have reached the same result regardless of what verbal rubric it had followed, intervention by this Court is neither necessary nor appropriate.[12]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

NOVEMBER 1984

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[12]Petitioner can point to no court of appeals decision even suggesting that another circuit would have reached a different result on the facts here, which quite plainly show an attempt to pass along to the IRS much of the cost of petitioner's continuing contributions to TAMDA's capital (see note 4, *supra*).

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